DEFERRED TAXES IN UTILITY RATE-MAKING

Cincinnati Gas & Electric Co. v. Public Utilities Commission of Ohio
173 Ohio St. 473, 184 N.E.2d 84 (1962)

On April 21, 1958, The Cincinnati Gas & Electric Company filed an application with the Public Utilities Commission of Ohio seeking a general rate increase. The Commission rendered findings and an order granting 70% of the requested increase.[1] The order also allowed the company to deduct, as an operating expense in determining income for rate-making purposes, the amount of federal income taxes which had been deferred until some time in the future by the use of accelerated depreciation methods in computing taxable income. The Commission stated that this treatment of deferred taxes was only temporary pending further study and experience.[2] Although the temporary treatment of the tax result of accelerated depreciation was favorable, the company was not satisfied with the result because of the absence of a final policy statement by the Commission. The company requested a rehearing which resulted in an order reducing the rate increase to 38% of the amount requested and disallowing normalization[3] of federal income taxes in rate determinations.[4] From this decision the company perfected an appeal to the Supreme Court of Ohio. In a per curiam decision, the court affirmed the Commission, holding that the orders were not unreasonable or unlawful.[5]

This case represents the final decision of the Public Utilities Commission of Ohio on the treatment to be accorded to the use of accelerated depreciation in determining federal income taxes. The decision is a change from the temporary treatment used in rate cases prior to the present one, and it is against the weight of authority in accounting and rate-making matters. As a result of this decision it is likely that the utility ratepayers of the state of Ohio will pay more for utility services than would have been the case if the Commission had continued to allow normalization. Furthermore, the policy established by the Commission cannot be uniformly and fairly

1 Cincinnati Gas & Elec. Co., 33 P.U.R.3d 1 (Ohio Pub. Util. Comm'n 1960), Ann. Rep. PUCO 1960, at 48.

2 *Id.* at 13, Ann. Rep. PUCO 1960 at 54.

3 As it is used in this context, the word normalization refers to the procedure of determining the federal income tax to be charged against income for rate-making purposes by using the straight-line method for computing depreciation, even though the declining-balance method was used in computing federal income taxes actually paid, so that income taxes will be distributed more evenly between years.

4 Cincinnati Gas & Elec. Co., 35 P.U.R.3d 392 (Ohio Pub. Util. Comm'n 1960).

5 Cincinnati Gas & Elec. Co., 173 Ohio St. 473, 184 N.E.2d 84 (1962). Ohio Rev. Code § 4903.12 provides that only the Supreme Court shall have power to review, suspend or delay any order of the Public Utilities Commission. Section 4903.13 provides that a final order of the Commission shall be reversed by the Supreme Court if, upon consideration of the record, the court is of the opinion that the order was unlawful or unreasonable.

applied to all the companies across the state which will be affected by this decision. By making the use of accelerated depreciation unattractive to utility companies in the state, the Commission also blocks efforts of the federal government to stimulate the economy by providing such tax measures designed to increase investment in new plant facilities and modernization.[6]

The problem in the present case arose when the company elected to use the declining-balance method of computing depreciation in determining taxable income[7] while continuing to use the conventional straight-line method for financial reporting of income and for rate-making. As a result, federal income taxes actually paid were lower than if straight-line depreciation had been used for tax purposes. It was the contention of the company that the difference between taxes actually paid and those which would have been paid on a straight-line basis represented only a deferral of the payment of the tax and that a liability to pay the tax at some time in the future existed. This view is in accordance with the holdings of the Federal Power Commission[8] and a number of the state regulatory commissions,[9] as well as generally accepted accounting principles.[10]

At the rehearing on the company's application, the Commission held that the tax result of the use of accelerated depreciation was not a deferral and that no liability to pay these taxes existed, but that the result was a tax saving which should be passed on to the consumers.[11] The Commission based this decision on the testimony of Dr. Robert Eisner, a professor of economics at Northwestern University. Dr. Eisner testified that as a result of the continued physical expansion of the company, its taxable income would always be less than reported net income, and that, therefore, the company would never have to pay these taxes.[12]

This theory rests on an assumption which is speculative, and which is not applicable to all the companies that will be affected by the decision in this case. The assumption is that the company will continue to expand, and that physical additions to the utility plant that can be depreciated will always be as great or greater than the year before. While this assumption

6 These points are discussed more fully below.

7 Int. Rev. Code of 1954, § 167(b)(2) permits the use of the declining-balance method of computing depreciation. Using this method, a fixed percentage of the undepreciated cost of the asset is charged to expense each year. The rate of depreciation may be as great as twice the rate which would be used under the straight-line method. Each year the amount of depreciation charged to expense for a particular asset will decrease.

8 City of Lexington v. Federal Power Commission, 295 F.2d 109 (4th Cir. 1962).

9 Among the states which have allowed normalization are Illinois, Indiana, Kentucky and Michigan. Prior to the decision in this case, the states which had decided the issue of normalization were equally divided on the question. States which do not allow normalization are, among others, California, New York and Pennsylvania.

10 American Institute of Certified Public Accountants, Accounting Research Bulletin 44 (Revised) (1958).

11 Cincinnati Gas & Elec. Co., *supra* note 4, at 397-398.

12 *Id.* at 396-397.

may be true for a long period of time in the case of the Cincinnati Gas & Electric Company, one of the largest utilities in the nation, it would seem that at some point the area served by the company will become so saturated that such expansion will no longer be possible. At that time, the depreciation charges allowable for federal tax purposes will begin to decline, and each year they will become smaller. As this happens, taxable income will rise. The question then arises whether the Commission would continue to allow taxes on an "as paid" basis when the taxes are higher than would be the case if computed using the straight-line method.[13]

There are many small utility companies serving smaller areas which are not growing at such a constant and rapid rate, and which cannot maintain the level of capital investment required to justify the assumption on which this decision is based. Such a company may make small additions to its system each year, and only rarely make a very large addition.[14] In such a case, the use of accelerated depreciation coupled with normalization could be of great assistance of financing a large addition, and would certainly not result in a tax saving. Consumers would benefit from better service resulting from improved facilities and from the lower financing charges which the company would pay.

The assumption that a public utility will continue to expand and will never be called upon to pay taxes deferred by the use of accelerated depreciation was criticized by the Supreme Court of Illinois in a recent case where the court recognized several very real and not unlikely events which might force payment of these taxes.[15] Should any of these events occur, the policy declared in this case will give present ratepayers of a utility which elects to use accelerated depreciation for federal income tax purposes

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[13] Accounting Research Bulletin 44 (Revised), *op. cit. supra* note 10, at 3A also raises the question by saying:

> However, where charges for deferred income taxes are not allowed for rate-making purposes, accounting recognition need not be given to the deferment of taxes *if it may reasonably be expected that increased future income taxes, resulting from earlier deduction of declining-balance depreciation for income tax purposes only, will be allowed in future rate determination.* (Emphasis added.)

[14] Some examples of this type of company which come readily to mind are a water company in a smaller town which adds to its system a new reservoir or must replace its pumping and purification facilities, a similarly situated telephone company which converts to the dial system or installs direct-dialing equipment, or any other company which must invest in modernization of its system at widely separated intervals.

[15] City of Alton v. Illinois Commerce Commission, 19 Ill. 2d 76, 90, 165 N.E.2d 513, 521 (1960):

> However, several not unlikely events might occur which would prove the assumption erroneous. A war, a general depression or a decline in local market might curtail a utility's capital expenditures, and prevent further tax deferrals. As a result, taxes might increase just at the time when economic circumstances would make the added expense most burdensome. It is also possible that section 167 will be repealed, thus ending further tax deferrals.

the benefit of lower rates now at the expense of future ratepayers who will be forced to contribute funds to pay the deferred taxes for which no provision was made today. If the Commission allows the company to collect taxes only on an "as paid" basis, future ratepayers will pay for benefits received by someone in the past. In *Accounting Research Bulletin 44 (Revised)*—which stated that to avoid income distortion and to equitably match income and expense within the proper period, deferred taxes should be recognized—the American Institute of Certified Public Accountants acknowledged that taxes might be deferred over a long period of gradual expansion, but, nevertheless, stated that generally accepted accounting principles required that provision be made for these taxes.[16] Thus, another authoritative body which is directly concerned with the problem of income determination, which is the basic problem in this case, has spoken in favor of normalization.

The Commission sought to pass on to the consumer the benefits which could be derived from the use of accelerated depreciation. Under the Commission's present policy this benefit would be in the form of reduced rates resulting from lower taxes. But as discussed above there is a distortion of income under such a policy which in effect means that the savings in the form of lower rates paid by consumers today do not come from the use of accelerated depreciation, but rather come from a part of the rates to be paid by future ratepayers. If normalization were allowed, the consumer would benefit in at least two ways. First, he would benefit from lower rates resulting from the decrease in financing and other costs which would follow from treating the deferred taxes as an interest-free loan from the federal government, and second, the consumer would benefit from better service through facilities financed from this source. A company which continues to use accelerated depreciation now faces increased risks such as the possibility that it will not be allowed to recover higher taxes paid in the future; that its credit standing will be impaired by the presence of a large, unfunded liability to the federal government; and that it will be forced to pay higher taxes for which no provision has been made, at a time when economic conditions might increase the hardship of such a payment. Therefore, it seems unlikely that a company free to choose between methods to be used for depreciation would elect to use accelerated depreciation. Instead, those companies now making use of accelerated depreciation will return to the use of the straight-line method for federal income tax purposes, and the increased taxes will be passed on to the consumer at the next rate proceeding.

If the consumer is to benefit under the present policy, then the Commission must go further, and *require* that utility companies use accelerated depreciation to minimize taxes. So far, only one state has adopted such a policy.[17] While others have recognized that strong arguments exist in favor

16 Accounting Research Bulletin 44 (Revised), *op. cit. supra* note 10.

17 Bangor Hydro-Elec. Co., 26 P.U.R.3d 489 (Me. Pub. Util. Comm'n 1958).

of such a policy, they did not decide the question.[18] Two states have allowed companies to return to the use of straight-line depreciation with the resulting higher taxes following decisions which did not allow normalization.[19] The New York Public Service Commission stated, when it announced its decision on treatment of accelerated depreciation, that a utility had an obligation to minimize taxes, but that the decision to use accelerated depreciation was a managerial determination.[20] However, in a later case the Commission did not allow deduction of federal income taxes where a company exercised the privilege of reinvesting the proceeds of an involuntary conversion in similar property to avoid the capital gains tax.[21] The company's election resulted in the new property having a lower basis for depreciation for tax purposes, which resulted in higher taxes, than if the company had paid the capital gains tax, which would not have been an operating expense, and reinvested the remaining funds in property.[22]

So that companies and the public might benefit from the liberalized depreciation provisions of section 167 of the Internal Revenue Code,[23] the procedure used in Illinois appears to offer the best solution. This policy recognizes the intention of Congress in providing for the use of liberalized depreciation methods, and conforms to generally accepted accounting principles. As a result, companies benefit by having an interest-free source of capital to finance expansion, and stockholders benefit from the provision which has been made for deferred taxes. The consumers pay lower rates as a result of lower capital costs and because deferred taxes are deducted from the rate base. Only under such a plan as this, or where utilities are required to use every possible election to minimize taxes, will the ratepayer receive any benefit from accelerated depreciation. Under the present rule in Ohio, only the federal government benefits by receiving the full amount of taxes due it on a current basis.

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[18] Tax Treatment of Accelerated Depreciation, 33 P.U.R.3d 209, 215 (Cal. Pub. Util. Comm'n 1960).

[19] City of Pittsburgh v. Pennsylvania PUC, 187 Pa. Super. Ct. 341, 144 A.2d 648 (1958); Housatonic Pub. Serv. Co., 22 P.U.R.3d 1 (Conn. Pub. Util. Comm'n 1958).

[20] Niagara Mohawk Power Corp., 28 P.U.R.3d 171, 194 (N.Y. Pub. Serv. Comm'n 1959).

[21] New York Water Serv. Corp. v. Pub. Serv. Comm'n, 12 App. Div. 2d 122, 208 N.Y.S.2d 857 (1960).

[22] Int. Rev. Code of 1954, § 1033.

[23] Int. Rev. Code of 1954, § 167.